INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

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MEMORANDUM FOR SECRETARY O'NEILL

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FROM: David C. Williams
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SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service

SUMMARY

The Reports Consolidation Act of 2000 requires that we summarize for you our perspective on the most serious management and performance challenges currently facing the Internal Revenue Service (IRS) for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2001*.

The Treasury Inspector General for Tax Administration's (TIGTA) assessment of the major IRS management challenge areas for Fiscal Year (FY) 2002 has not changed substantially from the prior year. While the IRS has acted to address each challenge area, TIGTA was able to remove only the challenge that addressed the organizational restructuring of the IRS. In addition, the TIGTA believes that two other issues will challenge the IRS in the coming years. *Human Capital* and *Complexity of the Tax Law* are being added to the TIGTA's list of challenges facing the IRS.

We have also recategorized or renamed some issue areas. Challenge areas formerly titled *Financial Management* and *Implementation of the Government Performance and Results Act of 1993* have been combined under one area titled *Performance and Financial Management*. The customer service issues previously included in the challenge area titled *Customer Service and Tax Compliance Initiatives* have been moved to the *Providing Quality Customer Service* challenge, leaving a challenge area titled *Tax Compliance Initiatives*. Issues in the challenge area formerly titled *Impact of the Global Economy on Tax Administration* have been incorporated in the *Tax Compliance Initiative* challenge area. The challenge previously titled *Revenue Protection – Minimizing Tax Filing Fraud* has been renamed *Erroneous Payments* to emphasize presidential and congressional concerns in this area.

The TIGTA believes the major management challenges, in order of priority, facing the IRS in FY 2002 are:

- Security of the Internal Revenue Service
  - Employees and Facilities
  - Information Systems
- Systems Modernization of the Internal Revenue Service
- Integrating Performance and Financial Management
  - Performance Management
  - Financial Management
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Complexity of the Tax Law
- Tax Compliance Initiatives
- Providing Quality Customer Service Operations
- Erroneous Payments
- Taxpayer Protection and Rights
- Human Capital

DISCUSSION

Discussion of the major IRS management challenge areas, including examples of relevant TIGTA audit work, follows.

Security of the Internal Revenue Service

The terrorist attacks on September 11, 2001, and the subsequent anthrax scare highlighted new vulnerabilities in many government agencies. Although the IRS has been security conscious because of the very nature of its work, security of IRS employees, facilities, and information systems is now considered as the number one challenge facing the IRS management for FY 2002.

Security of the Internal Revenue Service – The Employees and the Facilities

Immediately after the tragic events in New York City and Washington, DC, the IRS took steps to safeguard IRS personnel and assets. First, the IRS Security Standards were reviewed and upgraded as necessary. Second, a preliminary risk assessment survey was completed for all 785 IRS offices. The survey results will identify offices that need additional safety measures and help prioritize improvement projects. In addition, extra precautionary measures were implemented for mail and package handling.

Security of the Internal Revenue Service – The Information Systems

Considering the amount and sensitivity of the data the IRS is charged with protecting and the amount of revenue it collects, the IRS is a highly visible target for hackers, disgruntled employees, etc. Access to the Internet and the linking of internal computer systems have greatly increased the risk of loss or theft. Despite the IRS' significant efforts and accomplishments over the past few years, the overall level of security over the IRS' information systems is not yet adequate.

At the Internet gateways, which control external access into the IRS network, firewalls and routers were not upgraded to protect against commonly known weaknesses, configurations were weak, changes to configurations were not documented, activity logs were not generated or reviewed, and sufficient and capable staffing was not assigned to administer the firewalls. Furthermore, the IRS still does not have the capability to detect intrusions at all entry points from the Internet.

Internally, weaknesses with network operating system controls, physical security, and access privileges still exist. Due to the interconnectivity of systems within the IRS, these weaknesses are significant. Unauthorized persons gaining access to a computer in even the smallest post-of-duty can potentially access data in any of the computing centers. The IRS, however, still does not routinely run or review activity logs on network servers to detect potential internal security breaches.

Systems Modernization of the Internal Revenue Service

The IRS Restructuring and Reform Act of 1998 (RRA 98)[1] mandated that the IRS reorganize around groups of taxpayers with similar needs and place a greater emphasis on serving taxpayers and meeting their needs. The success of the IRS' reorganization is dependent upon revising its business processes and implementing new computer systems to better serve the specialized needs of these groups. Given the IRS' past history in modernizing its computer systems, this is a major challenge.

Some of IRS' key goals, such as 80 percent of tax returns being filed electronically by Year 2007 and significantly improving levels of service in answering taxpayer questions, are contingent on the development of new technology. Furthermore, while the development of new technology evolves, existing operations must continue plus improvements must be made to meet the needs of tax administration and to demonstrate to taxpayers the IRS' commitment to improved services.

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[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Integrating Performance and Financial Management

Improving performance is an overall goal of the federal government. Furthermore, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people.

Performance Management

The IRS management has taken several steps to address the issues concerning implementing the Government Performance and Results Act (GPRA),[2] administering the *Customer Satisfaction Survey* process, and managing the *Annual Program Performance Report* process. The IRS Commissioner designated the Deputy Commissioner and the Chief Financial Officer as responsible for the macro-level GPRA processes and the operating unit executives as responsible for implementing the GPRA in their respective areas. The IRS has made changes to its performance management process to help better define and report on measures and is planning to qualify some data. In addition, the IRS has issued procedures for reporting on the IRS' critical measures, requiring that data and supporting documentation be verified and approved prior to being reported to the Treasury Department.

Financial Management

According to the General Accounting Office's (GAO) report for the FY 2000 audit of the IRS, the IRS continues to face most of the pervasive systems and internal control weaknesses that have been reported each year since GAO began auditing the IRS' financial statements in FY 1992. Despite these weaknesses, in FY 2000 the IRS was able to produce, for the first time, combined financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. This achievement was the culmination of two years of extraordinary effort on the part of the IRS. The IRS developed compensating processes to work around its serious systems and control weaknesses in order to derive year-end balances for its financial statements. In addition, the IRS addressed several of the management issues raised in previous reports.

Achieving this unqualified opinion relied heavily on costly, time consuming processes, statistical projections, external contractors, substantial adjustments, and monumental human effort. These costly efforts would not have been necessary if the IRS' systems and controls operated effectively. In addition, the absence of effective systems and controls means that the IRS lacks, on an ongoing basis, the

[2] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

timely, accurate, and useful information needed to make informed management decisions.[3]

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season

The filing season impacts every American taxpayer and is, therefore, a highly critical program for the IRS. Programs, activities, and resources have to be planned and managed effectively each filing season. During the 2000 Filing Season, the IRS effectively processed paper individual tax returns. Nevertheless, the IRS could have more effectively implemented tax law changes during the 2000 Filing Season for certain program areas, such as the Child Tax Credits, Credits for the Elderly or the Disabled, Child and Dependent Care Credits, Mortgage Interest Credits, and Education Credits.

Furthermore, opportunities still exist for the IRS to more effectively implement tax law changes and process tax returns for business taxpayers. Some examples include ensuring only taxpayers liable for the corporate Alternative Minimum Tax actually pay the tax; ensuring the payment vouchers and tax returns accurately reflect the taxpayer name and identification number, developing controls to increase the accuracy of electronic partnership returns, identifying incorrectly filed Personal Service Corporation Income Tax Returns, and simplifying the estimated tax penalty computation.

Complexity of the Tax Law

Tax law complexity is the highest-ranking problem individual and business taxpayers had with the IRS, according to the *FY 2000 Taxpayer Advocate's Annual Report to the Congress*. The Advocate also identified tax law complexity as the root cause of many of the other problems on the Top 20 list, including clarity and tone of IRS communications, inability to access the toll-free number, compliance burden on small businesses, administration of the Earned Income Credit (EIC), lack of one-stop service, penalty administration, understanding federal tax deposits, and divorced and separated taxpayers issues.

In its *FY 2001 Annual Report to Congress*, the National Taxpayer Advocate takes tax law simplification a step further, focusing on key legislative proposals that create a more burdensome and confusing voluntary tax system for even the most compliant taxpayers. The report outlines proposals to simplify or clarify six areas of tax law – family status issues, joint and several liability, alternative minimum tax for individuals, penalty and interest issues, home-based service workers, and IRS collection procedures. It also lists additional legislative issues, as well as some potential legislative issues, that merit further consideration.

[3] *United States General Accounting Office Report to the Secretary of the Treasury – IRS' Fiscal Year 2000 Financial Statements*, March 2001.

The Joint Committee staff identified some causes of complexity: 1) a lack of clarity and readability of the law; 2) the use of the Federal tax system to advance social and economic policies; 3) increased complexity in the economy; and 4) the interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. In addition, the lack of clarity and readability of the law results from 1) statutory language that is, in some cases, overly technical and, in other cases, overly vague; 2) too much or too little guidance with respect to certain issues; 3) the use of temporary provisions; 4) frequent changes in the law; 5) broad grants of regulatory authority; 6) judicial interpretation of statutory and regulatory language; and 7) the effects of the Congressional budget process.

Tax Compliance Initiatives

The IRS' goal of providing world-class service to taxpayers hinges on the theory that, if the IRS provides the right mix of education, support, and up-front problem solving to taxpayers, the overall rate of voluntary compliance with the tax laws will increase. The challenge to the IRS management is to establish a tax compliance program (examining tax returns and collecting tax liabilities) that identifies those citizens who do not meet their tax obligations, either by not paying the correct amount of tax or not filing proper tax returns.

During the last decade, the number of tax returns selected for examination by the IRS has decreased, while the number of tax returns filed by taxpayers has increased. Additionally, revenue receipts processed by the IRS increased from $1.5 trillion in FY 1996 to $1.9 trillion in FY 2000. However, revenue collected as a result of compliance activity decreased by $5 billion and gross accounts receivable increased by $41 billion during the same period. Decreases in the examination rate can be partially attributed to fewer revenue agents and tax auditors, a decline in direct examination time, and an increase in time per return by revenue agents. Decreased enforcement has been attributed to reduced resources allocated to compliance activities and IRS employees' concerns over the mandatory employment termination provision in Section 1203 of RRA 98.

Providing Quality Customer Service Operations

Providing top quality service to every taxpayer in every transaction is integral to the IRS' modernization plans. There are many ways in which the IRS provides customer service. The most direct include toll-free telephone service, electronic customer service, written communications to taxpayers, walk-in service, and accurate and timely tax refunds. Each of these services affects a taxpayer's ability and desire to voluntarily comply with the tax laws. Providing these services in a high-quality manner can also be a challenge to the IRS.

Quality service at IRS Taxpayer Assistance Centers (TAC) continues to be a major concern. Both an IRS study conducted during the 2000 Filing Season and a TIGTA audit conducted during the 2001 Filing Season reported low accuracy rates on tax law questions answered by a sampling of IRS assistors. In addition, TIGTA auditors, who posed as walk-in taxpayers, were not provided correct or sufficient answers 73 percent of the time, and, in some instances, were treated with discourtesy or had excessive wait time. Audit test calls to the Spanish language option on the IRS' toll-free telephone helpline identified a need for improvement in the quality of responses being provided to Spanish-speaking taxpayers asking tax law questions.

Internet technology affords the IRS many opportunities to dramatically improve customer service, and the IRS has made strides in using these technologies. An IRS web site that provides taxpayers with convenient access to tax forms and information received over one billion accesses during this past filing season alone. However, inadequate systems design and planning have hindered other efforts. For example, to better serve customers and relieve some of the call volumes from the toll-free system, the IRS has been planning, since 1996, to implement an Internet-based refund status application. This application is now scheduled to be available to taxpayers by the beginning of the 2002 filing season.

Erroneous Payments

Both the President and the Congress have expressed concerns with the large amount of erroneous payments made by Federal agencies. Improper payments include inadvertent errors; payments for unsupported or inadequately supported claims; payments for services not rendered; payments to ineligible beneficiaries; and payments resulting from outright fraud and abuse by program participants and/or federal employees. Stewardship responsibility over public funds is a major challenge facing IRS management.

The EIC Program continues to be a highly visible area of potential fraud. To combat potential EIC fraud, the IRS launched promising new compliance initiatives. For example, partnerships with the Department of Health and Human Services and the Social Security Administration will permit the IRS to crosscheck information on the child and the taxpayer. However, despite extensive IRS programs and efforts to address certain refund schemes, relatively little effort has been made to systematically identify those schemes involving business returns and associated credits. While a few business schemes have been identified, it has generally been through labor-intensive manual procedures. The IRS is concerned that fraudulent refund claims may be expanding to include business returns, and that scheme perpetrators may be using the Internet or other means to promote and advertise their schemes.

Taxpayer Protection and Rights

The RRA 98, which was signed into law on July 22, 1998, contains 71 provisions that increase or help protect taxpayers' rights. The IRS is now fully compliant with three provisions, i.e., *Mitigation of the Failure to Deposit Penalty* (*RRA § 3304(a)), Seizure of Property* (*RRA §§ 3401(b) and 3421),* and *Notice of Levy (RRA 98 § 3401(b))*. For another seven provisions, the IRS is taking additional corrective actions to increase compliance. However, the IRS did not fully comply with two of the RRA 98 provisions because of delays and other implementation problems. Additional actions are needed to implement these provisions: *Dual Notices for Joint Filers (RRA 98 § 3201)* and *Collection Statute Extensions (RRA 98 §§ 3461(a) and (c)).* An extension of the implementation deadline had been requested or the compliance could not be fully evaluated on another six provisions.

Additionally, the IRS Commissioner has expressed, before the Congress, concerns about treating taxpayers fairly. The IRS has indicated to the Congress its commitment to treat all taxpayers equitably, and strategic plans indicate equitable treatment of taxpayers is included in efforts to promote compliance among business taxpayers. However, the TIGTA is concerned about possible inequities between the different taxpayer groups. For example: the Wage and Investment Income (W&I) Division characterizes its taxpayers as highly compliant, which it attributes to its document-matching program. Conversely, the Small Business/Self-Employed (SB/SE) Division acknowledges that the largest part of the tax gap is attributed to the taxpayers it serves. Business income, however, is not subject to similar matching programs.

Human Capital

Like many other government agencies, the IRS faces a range of serious personnel management issues, ranging from recruiting, training, and retaining employees to problems associated with the IRS' recent reorganization and modernization efforts. During FY 2001, the IRS struggled with a continuing need to properly staff, train, and provide adequate tools for employees. In some cases, such as the lack of resources for visually impaired telephone assistors, the IRS was at risk of civil suits.

Retention of a qualified work force continues to be a challenge for the IRS, particularly the Large and Mid-size Business (LMSB) and SB/SE Divisions. During the recent reorganization, much of the experienced staff were assigned to these divisions, and many of these employees will be eligible for retirement within the next five or six years. Both the LMSB and SB/SE Divisions have taken various steps to establish a human capital plan. The LMSB Division developed an accelerated skill attainment program, a coaching/mentoring implementation plan, and an innovative recognition program. The SB/SE Division developed a learning and education organization blueprint and conducted career path reviews.

Discussion of the issue removed from the major IRS management challenge areas follows.

Modernization of the Internal Revenue Service – Organizational Restructuring

On October 1, 2000, IRS achieved the first milestone toward modernization by implementing its new organizational structure. The four major components of the new IRS – the W&I, the SB/SE, the LMSB, and the Tax Exempt and Government Entities (TE/GE) Division – substantially completed the critical elements needed for standing up. Specifically, most key management positions were filled, most employees had been realigned, finance offices and budgets were established, many delegations of authority were revised, and detailed plans of workarounds[4] were developed. In addition to the four major business units, other key IRS offices, such as the Criminal Investigation function, the Taxpayer Advocate Service, and the Appeals function, also successfully implemented a new structure. Therefore, the TIGTA believes that the organizational restructuring is complete but, to be effective, new business processes and computer systems need to be implemented. The new processes and systems implementation will be examined under the other challenge area.

The complete document reflecting the TIGTA's comprehensive analysis of the major management challenges facing the IRS in Fiscal Year 2002 can be viewed at the following Internet address: http://208.45.140.254/tigta/fy2002-challenges-jpa-rev010902.doc

[4] Temporary solution to a problem that allows a new organization to be operational until a final solution can be developed and implemented.